

Author: Walters Analyst: Anne Mazur Bill Number: AB 561
 Related Bills: See Legislative History Telephone: 845-5404 Introduced Date: February 21, 2007
 Attorney: Douglas Powers Sponsor: Franchise Tax Board (FTB)

SUBJECT: Amnesty Relief

SUMMARY

This bill would provide relief to certain taxpayers with respect to the 2005 income and franchise tax amnesty as follows:

1. Allow taxpayers to request Chief Counsel review for relief of the amnesty penalty if certain criteria are met.
2. Convert the existing post-amnesty penalty to additional interest for liabilities that become final after the end of amnesty.
3. Eliminate the amnesty penalty on balance due amounts that are generated as a result of a post-amnesty change in interpretation or application of law.
4. Change the rate of interest for corporate taxpayers that filed protective claims in lieu of participating in amnesty so that any overpayment would bear the same interest rate imposed on underpayments.
5. Eliminate all or a portion of the amnesty penalty for taxpayers that made protective claim payments for anticipated additional post-amnesty tax liabilities.

Each of these provisions is discussed separately in this analysis.

PURPOSE OF THE BILL

The purpose of this FTB-sponsored bill is to provide relief for certain unintended consequences of amnesty.

POSITION

Support.

On September 7, 2005, and December 7, 2005, the Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language included in this bill.

Board Position:

<u> X </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> </u> PENDING

Department Director

Date

Selvi Stanislaus

3/28/07

SUMMARY OF ECONOMIC IMPACT

Estimated Revenue Impact of AB 561 Assumes Enactment After June 30, 2007 (\$ in Millions)				
	2006/07	2007/08	2008/09	2009/10
Chief Counsel Relief of the Amnesty Penalty				
Reduction in penalties	– \$6	– \$6	– \$2	a/
Return of Protective Claims and Future Revenue Offsets	– \$50	+ \$25	+ \$15	+ \$10
Convert Post-Amnesty Penalty to Additional Interest	– \$1	b/	b/	b/
Amnesty Penalty Exclusion For Post-Amnesty Interpretation of Law	c/			
Interest Rate on Corporation Overpayments Same as Underpayments	– \$28	– \$16	– \$9	– \$8
Post-Amnesty Penalty Relief For Taxpayers That Made Protective Claim Payments	– \$9	– \$1	a/	a/
Adjustments for Interaction of Provisions ¹	+ \$25	– \$11	– \$7	– \$5
Total Revenue Impact of this Bill	– \$69	– \$9	– \$3	– \$3

a/ A loss less than \$500,000.

b/ A loss less than \$150,000.

c/ It cannot be predicted which, if any, laws or regulations will be re-interpreted in the future. Consequently, no revenue effect can be assigned to this proposal.

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

Individual revenue discussions are included separately below for each provision.

¹ The revenue impact of each of the provisions included in this bill was estimated as if each were enacted independent of any other provision; however, if enacted together, the provisions interact with one another and impact the revenue estimate for the bill as a whole. For example, the provision that would permit Chief Counsel relief of the amnesty penalty interacts with both the provision that would increase the interest rate on corporate overpayments and the provision that would provide relief for taxpayers that made protective claim payments.

LEGISLATIVE HISTORY

AB 2326 (Walters, 2005/2006) would have provided relief from various provisions of the income and franchise tax amnesty program identical to relief provisions proposed in this bill. The bill was held in the Assembly Appropriations Committee.

AB 911 (Chu, Stats. 2005, Ch. 398) made various clean-up amendments to the income and franchise tax amnesty program.

AB 1614 (Klehs, 2005/2006) would have provided relief from various provisions of the income and franchise tax amnesty program. This bill was held in the Senate Revenue and Taxation Committee.

SB 1100 (Senate Budget Committee, Stats. 2004, Ch. 226), among other things, established a tax amnesty program.

BACKGROUND

General Electric Corporation filed an action for declaratory relief with respect to the amnesty penalty on amounts that become due and payable after March 31, 2005. The action requests a determination of the meaning of the phrase "due and payable" and a declaration that the amnesty penalty (equal to 50% of the interest on unpaid amounts as of March 31, 2005, for years beginning before January 1, 2003) violates the Due Process Clause of the United States Constitution because of the lack of a remedy. The Attorney General's office is defending this action for the department. The trial court sustained the Attorney General's initial objections to the lawsuit on grounds that a penalty has not yet been assessed and thus the lawsuit was not yet "ripe." Oral hearing is pending in the California Court of Appeal for General Electric's appeal of the lower court's decision. There are few other litigation cases pending that have contested the amnesty penalty paid in connection with other tax issues. Taxpayers' arguments relating to the amnesty penalty become relevant only if the taxpayer loses on the merits of those underlying issues. It is presently unclear what impact, if any, these lawsuits may have on the provisions of this bill.

1. CHIEF COUNSEL RELIEF OF AMNESTY PENALTY

EFFECTIVE/OPERATIVE DATE

This provision would be effective for requests for Chief Counsel relief made on or after January 1, 2008, and operative for penalties imposed under section 19777.5(a) after March 31, 2005.

ANALYSIS

STATE LAW

Tax Amnesty

SB 1100 (Stats. 2004, Ch. 226) authorized FTB to administer a tax amnesty for individual and business entity taxpayers with respect to tax liabilities for taxable years beginning before January 1, 2003. Amnesty was conducted during the period beginning February 1, 2005, and ending March 31, 2005. Taxpayers participating in amnesty received a waiver of unpaid penalties and fees. Taxpayers that chose not to participate are subject to new and enhanced penalties with respect to any new and existing liabilities for amnesty-eligible years.

The amnesty penalty imposed under Revenue and Taxation Code section 19777.5(a)(1) is an amount equal to 50% of the accrued underpayment interest payable under section 19101 for the period beginning generally on the original due date of the return for the taxable year to the last date of the amnesty period of March 31, 2005. This penalty applied to balances outstanding on March 31, 2005.

The amnesty penalty imposed under section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in section 19101 for the period from the original due date of the return for the taxable year to the last date of the amnesty period, March 31, 2005. This penalty is applied to amounts that become due, including final deficiencies and amounts that are self-assessed, after March 31, 2005.

The penalty under section 19777.5(a) is applied without exception if the conditions described above exist. In addition, current law prohibits a taxpayer from filing a claim for refund for any amounts paid in connection with the amnesty penalty, except on the grounds that department staff improperly computed the penalty.

Voluntary Compliance Initiative

Taxpayers subject to certain tax shelter-related penalties may request the Chief Counsel of the Franchise Tax Board to grant relief. The standards for granting such relief depend on the specific penalty. For example, the Chief Counsel relief of the penalty under section 19773 for a reportable transaction understatement requires all of the following to apply:

- The taxpayer has a history of complying with relevant income tax laws.
- The violation is due to an unintentional mistake of fact.
- Imposing the penalty would be against equity and good conscience.
- Rescinding the penalty would promote compliance with relevant income tax requirements and effective tax administration.

THIS PROVISION

This provision would permit taxpayers to request the Chief Counsel of the Franchise Tax Board to grant relief from the amnesty penalty² if one of the following criteria exists:

- The taxpayer demonstrates that there was substantial authority, as defined, for the treatment of an item resulting in the underpayment on which the penalty was imposed.
- The taxpayer was first contacted after the end of the tax amnesty period by the IRS regarding an examination, which results in a final deficiency or self-assessed amount upon which the penalty would be imposed.
- Taking into account all the facts and circumstances, it would be against equity and good conscience to impose the penalty.

In instances where the Chief Counsel denies relief, this provision would permit taxpayers to file a claim for refund of an amount paid in connection with the penalty on the grounds that the Chief Counsel's failure to grant relief was an abuse of discretion.

IMPLEMENTATION CONSIDERATIONS

Over one million bills imposing the amnesty penalty were mailed to taxpayers that did not participate in or defaulted from tax amnesty and had balances due at the end of the amnesty period. A substantial number of taxpayers receiving these bills may request relief. A substantially smaller number of taxpayers with liabilities that become final after the end of the amnesty period may also request relief from the post-amnesty penalty under this proposal.

OTHER STATES' INFORMATION

States that recently administered amnesty programs were reviewed. *Illinois* imposed double the penalties and interest for existing and future balances not satisfied during amnesty. The doubled penalties and interest may be waived or abated with a showing of reasonable cause. *New York* imposed an additional 2% rate of interest on any existing assessment and on any future liabilities; no relief provision was expressly provided. *Virginia* imposed a penalty in the amount of 20% of any unpaid balance; no relief provision was expressly provided. *Indiana* doubled the amount of penalties originally assessed for balances not satisfied during amnesty. It appears states other than *Illinois*, *New York*, *Virginia*, and *Indiana*, with recent amnesty programs, did not impose an additional penalty or increased interest rate on balances not satisfied under amnesty.

FISCAL IMPACT

This provision would require additional resources to process a potentially large volume of requests for relief from the amnesty penalty. Department staff assumes that the department would receive 16,250 requests for relief resulting from the mailing of 1,025,000 bills referenced under Implementation Considerations, above. Because this large mailing is a one-time event, this workload would require resources for a limited period, assumed to be two years, at a cost of approximately \$264,000. This cost is primarily attributable to non-professional Legal resources for front-end processing. An appropriation would be required to fund these costs. Costs related to attorney-level resolution would be absorbed by the department.

² Or, as the case may be, the amnesty interest amount established by this bill. See in this analysis 2. CONVERT POST-AMNESTY PENALTY TO ADDITIONAL INTEREST.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this proposal would result in the following foregone penalty collections and potential return of some protective claim payments.

Estimated Revenue Impact Chief Counsel Relief of the Amnesty Penalty Assumes Enactment After June 30, 2007 (\$ in Millions)				
	2006/07	2007/08	2008/09	2009/10
Chief Counsel Relief of the Amnesty Penalty				
Reduction in penalties	– \$6	– \$6	– \$2	a/
Return of Protective Claims and Future Revenue Offsets*	– \$50	+ \$25	+ \$15	+ \$10
Total	– \$56	+ \$19	+ \$13	+ \$10

a/ A loss less than \$500,000.

* Future revenue offsets include future payments and reduced future refunds.

Revenue Discussion

The revenue effects of this provision would be determined by: (1) the amount of foregone amnesty penalty assessments and collections, and (2) the potential return of protective claim payments and the equivalent future revenue offsets.

Based on the department's experience with penalty relief requests relative to other tax programs, it is assumed that the Chief Counsel would abate in the initial year approximately 10% of amnesty penalties imposed, dropping to 7% beginning with 2008/2009. The drop from 10% to 7% would be attributable to the standard for penalty relief relating to initial IRS contact for audit after the end of amnesty for amnesty eligible years. The revenue impact from granting relief based on this standard would become negligible in 2008/2009 and thereafter because the federal statute of limitations for the 2002 taxable year will begin to expire in early 2006. The remaining 7% of penalty relief would be attributable to the "substantial authority" and the "equity and good conscience" standards. Penalty estimates are accrued back one year.

Permitting taxpayers to request Chief Counsel review of the imposition of the amnesty penalty would encourage some taxpayers to request the immediate return of their protective claim payments. Of the \$3.5 billion in protective claim payments, it is estimated that 1% to 2%, or \$50 million, would be withdrawn. When these cases are resolved, there will be offsetting revenue flows. Some of the offset will be from the repayment of withdrawn money; the remainder will be from a reduction in refunds by amounts that would have been refunded upon resolution had the money not already been withdrawn. It is assumed that offsets will occur over a three-year period.

Returned protective claim payments are attributable to taxpayers that believe they would be granted relief under either the "substantial authority" or the "IRS contact" standards of relief. The \$50 million outflow for 2006/2007 (on a cash-flow basis) is estimated as follows:

- Under the "substantial authority" standard of relief, the outflow would be \$30 million, and
- Under the "IRS contact" standard of relief, the outflow would be \$20 million.

Offsets would produce revenue gains totaling \$50 million over the following three years. Estimates are accrued back one year.

ARGUMENTS/POLICY CONCERNS

Permitting a taxpayer to request Chief Counsel review of the imposition of the amnesty penalty in particular circumstances would allow relief from the penalty where imposition of the penalty would be particularly harsh because: (1) the taxpayer can demonstrate substantial authority for the tax return position, (2) the taxpayer was not aware that the IRS would audit their tax return and propose an adjustment, or (3) based on the facts and circumstances of the specific case, it would be against equity and good conscience to impose the penalty.

Some taxpayers that already paid any assessments of the amnesty penalty may be time barred from requesting relief in the form of a claim for refund. Generally, a taxpayer may file a claim for refund no later than four years from the date of a timely filed tax return or one year from the date of overpayment. It is likely the four-year statute of limitations will have expired for amnesty years--beginning before January 1, 2003--by the presumed effective date of this bill. For some taxpayers, depending on the date they paid the amnesty penalty, the one-year statute of limitations may also be expired. Therefore, such taxpayers would not be able to seek the remedy intended by this provision.

2. CONVERT POST-AMNESTY PENALTY TO ADDITIONAL INTEREST

EFFECTIVE/OPERATIVE DATE

This provision would become effective on January 1, 2008, and operative as of that date, with respect to liabilities that become final after March 31, 2005.

ANALYSIS

STATE LAW

The amnesty penalty imposed under section 19777.5(a)(2) is an amount equal to 50% of the underpayment interest computed at the rate referenced in section 19101 for the period from the original due date of the return for the taxable year to the last date of the amnesty period, March 31, 2005. This penalty is applied for amounts that become due, including final deficiencies and amounts that are self-assessed, after March 31, 2005.

This penalty was modeled on the tax shelter penalty imposed by section 19777, which is measured by 100% of the interest payable under section 19101 for the period beginning with the last date prescribed by law for the payment of tax and ending on the date a notice of proposed assessment is mailed. Another tax shelter-related provision increases the underpayment interest rate to 150% of the normal underpayment interest rate for taxpayers that self-assess additional tax from a tax shelter before they are contacted by FTB.

Interest, including interest on a tax deficiency, is generally deductible by a corporation if it is incurred in connection with a trade or business. (*Redlark v. Commissioner* (9th Cir. 1998) 141 F.3d 936.) However, various federal courts, including the *Redlark* court, have, consistent with federal tax regulations, held that interest on individual income tax deficiencies is not deductible as a business expense, irrespective of the source of income giving rise to the tax deficiency.³

Federal and California court decisions provide authority for retroactive application of changes in law:

- The United States Supreme Court in *United States v. Carlton* (1994) 512 U.S. 26, overturned a 9th Circuit Court of Appeals decision that had held a retroactive legislative "correction" to an estate tax provision to be an unconstitutional violation of due process.
- The California Supreme Court in *Preston v. State Bd. of Equalization* (2001) 25 Cal. 4th 197, 224, found that retroactive application of a sales tax statute was permissible where there was unequivocal legislative intent to apply the statutory change retroactively and where the retroactive application did not impair any vested property right of the claimant.
- The California Supreme Court in *Allen v. Franchise Tax Board* (1952) 39 Cal. 2d 109, considered whether an income averaging statute could be applied retroactively to lump sum amounts received in 1940. The statute was an urgency statute that took effect February 4, 1941. FTB argued that the taxpayer's tax liability vested at the close of the taxable year, December 31, 1940, so the February enactment could not change the 1940 liability. The Supreme Court disagreed, holding that liability for tax vested on the original due date for payment (i.e., April 15, 1941).
- The California Supreme Court in *Mudd v. McColgan* (1947) 30 Cal. 2d 463, held that the statute of limitations on assessments could be lengthened for all assessments not already barred by the statute of limitations on the date of enactment. This was followed in *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal. 2d 472.
- The U.S. Court of Appeals, Second Circuit, in *Demartino v. Commissioner* (2d Cir. 1988) 862 F.2d 400, held that former IRC section 6621, which established a 120% increased interest rate on certain tax motivated transaction assessments, was constitutional because it applied only to cases where the statute of limitations had not expired or where no final judicial action had occurred.

³ See *McDonnell v. U.S.* (1999 WL 333230 (6th Cir. 1999) 180 F.3d 721; *Allen v. U.S.* (4th Cir. 1999) 173 F.3d 533; *Redlark v. Comm'r* (9th Cir. 1998) 141 F.3d 936; *Miller v. U.S.* (8th Cir. 1995) 65 F.3d 687; see also *Stecher v. U.S.* (D. Col. June 1) 1998 WL 427369; *In re Vale* (Bankr. N.D. Ind. 1996) 204 BR. 716, 739-44.

THIS PROVISION

This provision would impose interest at the rate of 150% of the normal underpayment rate for a specified period instead of imposing the existing post-amnesty penalty for assessments that become final after amnesty ended March 31, 2005. The additional interest provided under this proposal would be computed generally in the same manner as the post-amnesty penalty under current law.

The provision would name this additional interest—that is, the difference between normal interest and interest at a rate of 150% of the normal rate—the “amnesty interest amount.”

IMPLEMENTATION CONSIDERATIONS

This provision would require some form of communication to any corporate taxpayer that receives a bill for the post-amnesty penalty before enactment of this proposal to notify them of the change to additional interest.

In computing the amount of additional interest under this provision, any undesignated partial payments, including “protective claim” payments made outside amnesty, would be applied first to tax, then penalties, and finally to interest in accordance with federal procedures.⁴

FISCAL IMPACT

The estimated cost to implement this provision would be approximately \$150,000 for manual processing and modification of the accounting and collection systems to make the conversion from a penalty to additional interest. Some form of communication would have to be made with respect to any bills mailed to corporation taxpayers before enactment of this proposal that should have reflected an additional interest rather than a penalty. Staff does not anticipate a large volume for this manual workload. An appropriation would be required to fund these costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue loss from this proposal would be as follows:

Estimated Revenue Impact Convert Post-Amnesty Penalty to Additional Interest Assumes Enactment After June 30, 2007 (\$ in Millions)			
2006/07	2007/08	2008/09	2009/10
- \$1	a/	a/	a/

a/ A loss of less than \$150,000.

⁴ As explained in FTB Notice 2005-6, California follows Rev. Proc. 2005-18 with respect to deposits made to suspend running of interest on potential underpayments.

Revenue Discussion

This provision would impact revenue by increasing taxpayer deductions in the year the interest payments are made. This provision would convert post-amnesty penalty revenue to additional interest, and the portion of this interest paid by corporate taxpayers in connection with a trade or business would be deductible.

Based on department data, post-amnesty penalty payments that would be attributable to and deductible as a business expense by corporate taxpayers is projected to total \$22 million. Applying a 6% average tax rate, the total revenue impact would be approximately \$1.3 million (\$22m x 6% = \$1.3m.). It is assumed that this proposal would be enacted after the end of fiscal year 2006/2007 and, therefore, the revenue impact of interest payments made in prior years can only be accrued back to fiscal year 2006/2007.

LEGAL IMPACT

Despite legal authority upholding various retroactive changes in law, some taxpayers may challenge a retroactive imposition of interest as unconstitutional.

ARGUMENTS/POLICY CONCERNS

Although the additional interest contemplated by this proposal is labeled as interest, state law is not binding on the federal government. The IRS may determine that this additional interest is in fact a nondeductible penalty under the standards articulated in Rev. Rul. 78-196, 1978-1 C.B. 45.

Imposing additional interest more accurately connotes a fiscal remedy for a post-amnesty liability.

3. AMNESTY PENALTY RELIEF FOR POST-AMNESTY CHANGE IN INTERPRETATION OF LAW

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2008, and operative for amounts imposed under R&TC Section 19777.5(a) after March 31, 2005, that are attributable to changes in the interpretation of law that become final after March 31, 2005.

ANALYSIS

THIS PROVISION

This provision would establish an exception for computation of the post-amnesty penalty⁵ for that portion of any such penalty that is attributable to a change in interpretation of a law or rule of law by a regulation, legal ruling of counsel, as defined, or a published federal or California court decision that becomes final after the March 31, 2005, end of the amnesty period. This provision would only apply to the extent a post-amnesty change in interpretation impacted a taxable year beginning before January 1, 2003 (i.e., a year eligible for amnesty).

⁵ Or, as the case may be, the amnesty interest amount established by this bill. See in this analysis 2. CONVERT POST-AMNESTY PENALTY TO ADDITIONAL INTEREST.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would not significantly impact the department's programs or operations.

This provision would generally have to be implemented manually, usually by audit staff in the course of completing an examination. In the case of automated assessments, taxpayers would have to inform the department that an applicable law change exists to which the provision would apply.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

It cannot be predicted which, if any, laws or regulations will be re-interpreted in the future. Consequently, no revenue effect can be assigned to this provision.

ARGUMENTS/POLICY CONCERNS

Penalty relief for underpayments caused by post-amnesty changes in the interpretation or application of law would protect taxpayers from incurring the amnesty penalty in situations where the change in law could not have been reasonably anticipated by taxpayers.

Some taxpayers that already paid any assessments of the amnesty penalty may be time barred from requesting relief in the form of a claim for refund. Generally, a taxpayer may file a claim for refund no later than four years from the date of a timely filed tax return or one year from the date of overpayment. It is likely the four-year statute of limitations will have expired for amnesty years--beginning before January 1, 2003--by the presumed effective date of this bill. For some taxpayers, depending on the date they paid the amnesty penalty, the one-year statute of limitations may also be expired. Therefore, such taxpayers would not be able to seek the remedy intended by this provision.

4. ADJUST INTEREST RATE PAID TO CORPORATIONS ON OVERPAYMENTS MADE IN LIEU OF AMNESTY TO THE RATE OF INTEREST PAID ON UNDERPAYMENTS

EFFECTIVE/OPERATIVE DATE

This provision would be effective on January 1, 2008, and apply to any amounts refunded on or after that date for payments made under a protective claim in lieu of amnesty.

ANALYSIS

FEDERAL/STATE LAW

Under current federal law, the interest rate the Internal Revenue Service charges and pays to corporations for overpayments is the short-term federal rate plus two percentage points. The underpayment rate for corporations is the short-term federal rate plus three percentage points. For larger corporate overpayments, i.e., any portion that exceeds \$10,000, the rate is reduced to the sum of the short-term federal rate plus one-half of one percentage point. These rates are adjusted quarterly, with each successive rate becoming effective two months after the date of each quarterly adjustment. As of July 1, 2002, the federal interest rate for corporate overpayments was 5%, while the rate for corporate underpayments was 6%.

Current state law provides that in the case of any corporation, the overpayment rate specified is the lesser of 5% or the bond equivalent rate of 13-week U.S. Treasury bills, beginning on or after July 1, 2002. California modifies federal law by requiring that the overpayment rate for individual taxpayers be the same as the underpayment rate. The adjusted annual rate of interest applies to both overpayments and underpayments. The rate of interest on overpayments and underpayments is determined semi-annually. For the period beginning January 1, 2007, the rate charged for corporate underpayments is 8%, and the rate paid on corporate overpayments is 5%.

THIS PROVISION

For corporate taxpayers that made protective claim payments between January 1, 2005, and the March 31, 2005, end of amnesty, inclusive, this provision would increase the amount of interest paid by the state on an overpayment to be equal to the underpayment interest rate.

IMPLEMENTATION CONSIDERATIONS

The department's automated Business Entities Tax System (BETS) currently applies the overpayment interest rate on the total amount of an overpayment issued to a corporation. The proposed interest rate adjustment would need to be performed manually by staff because this automated system cannot accommodate the change made to the interest rate on an overpayment issued to some, but not all, corporations.

PROGRAM BACKGROUND

To encourage taxpayers to either participate in amnesty or self-assess known or suspected tax liabilities for years previously filed, the legislation established an additional penalty on amounts owed or new amounts assessed for taxable years beginning before January 1, 2003, that were not paid by March 31, 2005, the end of the amnesty period. The penalty is equal to 50% of the interest on the amount owed or to be owed.

Protective claims payments were made by taxpayers based on estimates of liabilities that might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements on any resulting deficiencies. A protective claim differs from the traditional claim for refund in that the taxpayer does not have to set forth the specific grounds on which the claim is based. Six hundred thirty-one (631) corporate taxpayers made protective claims payments in the amount of approximately \$3.5 billion for this purpose.

FISCAL IMPACT

The department's costs to administer this provision would require the interest rate adjustment to be handled manually by staff as described under Implementation Considerations. This would be done at a minor cost to the department.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact Interest Rate on Corporation Overpayments Same as Underpayments Assumes Enactment After June 30, 2007 (\$ in Millions)			
2006/07	2007/08	2008/09	2009/10
– \$28	– \$16	– \$9	– \$8

Tax Revenue Discussion

Just prior to the close of the amnesty period, corporations made payments totaling \$3.5 billion accompanied by protective claims for refunds. It is estimated that roughly \$1.3 billion of these payments will be refunded. The estimate assumes that approximately \$550 million of this amount will be refunded during the years 2008 through 2010. Because most of the overpayments were deposited in March 2005, refunds issued during the first half of 2008 will, on average, earn interest for 36 months; refunds issued in 2008/2009 will, on average, earn interest for 45 months; refunds issued in 2009/2010 will, on average, earn interest for 57 months; and refunds issued in 2010/2011 will, on average, earn interest for 69 months. The current interest rate differential between overpayments and underpayments of 3% was applied, with compounding of interest where appropriate, to the amounts anticipated to be refunded in each fiscal year (e.g., for refunds estimated to be issued in 2008/2009: \$135 million x 3% interest compounded for 3.75 years = \$16 million in interest). Under the state's accrual method, revenues from these refunds are recognized in the fiscal year prior to the year in which the refund is actually issued.

ARGUMENTS/POLICY CONCERNS

By adjusting the interest rate on overpayments for only the class of corporate taxpayers that made protective claim payments during a specified time period to avoid the amnesty penalty and not to all other corporate taxpayers with overpayments, this proposal could raise a constitutional challenge based on the argument that preferential treatment is given only to an identified class of taxpayers.

5. AMNESTY PENALTY RELIEF FOR TAXPAYERS THAT MADE PROTECTIVE CLAIM PAYMENTS

EFFECTIVE/OPERATIVE DATE

This provision would be effective January 1, 2008, and operative for amounts imposed under R&TC section 19777.5(a) after March 31, 2005.

ANALYSIS

THIS PROVISION

The provision would amend the law to eliminate all or a portion of the amnesty penalty⁶ for those taxpayers that made a sufficient protective claim payment (as objectively defined under the bill). The amount of relief would be based on 10% of the protective claim payment made before the end of amnesty.

IMPLEMENTATION CONSIDERATIONS

Because of the relatively small population of impacted taxpayers, the proposed penalty adjustment would be performed manually by staff.

PROGRAM BACKGROUND

Certain taxpayers made "protective claim" payments based on their estimate of amounts that might be owed in connection with ongoing or anticipated audits, protests, appeals, or settlements. Taxpayers that did not apply for amnesty made these payments by the end of the amnesty period to avoid imposition of the amnesty penalty, as provided under R&TC section 19777.5(a)(2), on any resulting deficiencies. Eight hundred thirty (830) individuals and business entities made these payments totaling approximately \$3.6 billion.

FISCAL IMPACT

The department's costs to administer this provision would require the penalty adjustment to be handled manually by staff as described under Implementation Considerations. This would be done at a minor cost to the department.

⁶ Or, as the case may be, the amnesty interest amount established by this bill. See in this analysis 2. CONVERT POST-AMNESTY PENALTY TO ADDITIONAL INTEREST.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this provision would result in the following revenue losses.

Estimated Revenue Impact Post-Amnesty Penalty Relief For Taxpayers That Made Protective Claim Payments Assumes Enactment After June 30, 2007 (\$ in Millions)			
2006/07	2007/08	2008/09	2009/10
– \$9	– \$1	a/	a/

a/ A loss of less than \$500,000.

Revenue Discussion

Department staff has previously estimated that amnesty penalties will generate \$168 million. This estimate assumes that approximately 20% of these penalties will be paid by taxpayers that made tax deposit payments and filed protective claims, but such payments were insufficient to cover their additional post-amnesty liabilities in full. Under this proposal, these taxpayers would be forgiven all or a portion of the post-amnesty penalty. This component of the estimate is derived by assuming that a quarter of post-amnesty penalties that would otherwise be assessed against these taxpayers would be relieved. ($\$168 \text{ million} \times 20\% \times \frac{1}{4} = \8.4 million.)

A second component of this estimate is comprised of taxpayers that made pre-payments for amnesty-eligible years outside of amnesty. Under the provision, this group of taxpayers also would be forgiven all or a portion of the amnesty penalty. This group is included in a limited but unknown number of taxpayers that would be paying the remaining 80% of \$168 million or \$134 million. For purposes of this estimate, it is assumed that these taxpayers represent 5% of the \$134 million, or \$6.7 million. It is assumed that a quarter of post-amnesty penalties that would otherwise be assessed against these taxpayers would be relieved. ($\$6.7 \text{ million} \times \frac{1}{4} = \1.7 million.)

Component estimates were summed and spread across fiscal years in the same proportion and timing of estimated future amnesty penalty assessments and collections. ($\$8.4 \text{ million} + \$1.7 \text{ million} = \$10.1 \text{ million.}$) Estimates are rounded to the nearest million and accrued back one year.

ARGUMENTS/POLICY CONCERNS

Some taxpayers that already paid any assessments of the amnesty penalty may be time barred from requesting relief in the form of a claim for refund. Generally, a taxpayer may file a claim for refund the later of four years from the date of a timely filed tax return or one year from overpayment. It is likely the four-year statute of limitations will have expired for amnesty years--beginning before January 1, 2003--by the presumed effective date of this bill. For some taxpayers, depending on the date they paid the amnesty penalty, the one-year statute of limitations may also be expired. Therefore, such taxpayers would not be able to seek the remedy intended by this provision.

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